

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
EQUITY REAL ESTATE LEVERAGE**

August 16, 2004

This Policy is effective upon adoption and supersedes all previous real estate investment leverage policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Equity Real Estate Leverage Program. The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Equity Real Estate Leverage Program ("the Program"). Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the market.

II. STRATEGIC OBJECTIVE

The System shall employ a prudent use of leverage in the real estate portfolio to enhance investment returns with full consideration of the impact of such leverage on overall investment risk. Leverage at property, portfolio, and corporate levels shall be acceptable with a preference for the most efficient and flexible borrowing structure available. The required rate of return on leveraged investments shall reflect the increase in investment risk due to the use of leverage.

III. REAL ESTATE LEVERAGE POLICY

A. Debt Limitations

1. Private Core Real Estate Portfolio

Specific terms of leverage agreements shall vary according to market conditions. However, the consolidated principal amount of leverage on the private portion of the Core Real Estate Portfolio shall not exceed 50% of the System's share of the gross market value of the investment. Staff shall have the right to allocate a higher leverage level than 50% to a core sector as long as the overall Core Portfolio leverage does not exceed 50%. Notwithstanding the above, any

leverage above 40% placed on the Core Portfolio must first be approved by the System's Real Estate Consultant and the Chief Investment Officer. Approval of any debt to be placed by our Partners/Managers must be pre-approved by Staff. Consolidated leverage shall include all types of financing without limitation, property-specific debt, tax-exempt bond financing, construction financing, and portfolio level financing. If the consolidated leverage ratio exceeds 50% for any reason, the Investment Manager shall use all reasonable efforts to reduce such leverage to the 50% level within a maximum cure period of one year. The Investment Committee shall receive reports concerning any exception regarding leverage in the Real Estate Quarterly Performance Report. The annual investment plan, promulgated by the investment manager and approved by the System, shall govern the use of financing proceeds. The debt service coverage ratio shall measure no less than 1.75:1 for portfolio-level debt and no less than 1.25:1 for property-level debt. The ratio measures the amount of annual cash flow available for making payments on borrowings relative to the annual debt service obligation.

2. Public Real Estate Securities Portfolio

Public Core real estate investments may also include leverage at levels consistent with market conditions. Public real estate securities shall be considered Specialized when leverage has a material impact on overall investment risk.

3. Specialized Real Estate Portfolio

Leverage may be employed in the Specialized Real Estate Portfolio at higher levels to enhance investment returns. The level of leverage shall be specified for each of these investments prior to approval. The increased risk associated with higher levels of leverage shall be considered in establishing acceptable rates of return.

B. Collateral

Borrowings may be structured in public or private, and secured or unsecured formats; however, recourse shall be limited in all cases to the real estate investments in the portfolio. The System shall not guarantee such financing without specific approval from the Investment Committee. Acceptable collateral includes, but is not limited to, the System's wholly owned direct equity real estate or the System's partnership or joint venture interest.

C. Origination

The System, its partners or investment managers, or third parties may arrange borrowings. Origination costs will vary with market conditions. To the extent that the System, its partners, or investment managers arrange borrowings, the following shall apply:

1. Unaffiliated third parties are not precluded from providing such services;
2. The cost of such services is at market rate; and
3. The System shall approve, in advance, the use of affiliates, the services provided, and the terms thereof.

D. Term/Rate Structures

Terms of leverage structures shall not exceed 30 years for conventional financing and 40 years for tax-exempt or Federal National Mortgage Association (Fannie Mae) or Federal Home Loan Mortgage Corporation (Freddie Mac) financing.

Interest rate structures may include fixed or variable/floating interest rates and amortizing or non-amortizing structures. Hedging techniques to control interest rate risk may be used including, but not limited to interest rate swaps, interest rate caps, and collars. Prudent use of both fixed and variable/floating interest rate structures are appropriate in a dynamic real estate portfolio under the following circumstances:

1. Fixed rate structures are generally used on stabilized properties (i.e., those properties that are producing a fairly stable income stream). In environments where interest rates approach or move toward historical low points, longer terms are generally most appropriate. As interest rates move towards higher historical levels, shorter terms are more appropriate, if leverage is used at all.
2. Variable/floating interest rate structures are generally used on development and value enhanced projects, and in situations where flexibility is needed, such as when a stabilized asset is being positioned for sale.

The appropriate ratio of fixed versus variable/floating debt is dependent upon the strategy, the life cycle of the program, the assets being financed and the position of the overall historical market interest rate cycle. While a fixed rate structure offers protection against interest rate increases, it is less flexible due to

the heavy prepayment penalties that lenders usually require. Variable or floating interest rate structures offer lower interest rates up front and generally the flexibility to prepay debt without a prepayment penalty, but they are subject to rising market interest rates over time. Thus, active management of portfolio debt structures is crucial and becomes more important as the amount of leverage increases within a portfolio.

E. Prepayment Provisions and Collateral Flexibility

Where prepayment provisions are necessary, would generally be preferred over lock-in and yield maintenance requirements. It is important within fixed rate structures to negotiate substitution collateral rights and/or one time assumption rights in order to prevent loans from becoming due on sale when disposing of individual real estate assets.

F. Risks and Risk Mitigation

Inherent in the use of leverage are risks which require active prudent debt management. The following are the major risks and some risk mitigation techniques:

1. **Volatility Risk:** Increasing the portfolio leverage will increase the portfolio's volatility, magnifying both positive and negative changes in appreciation/depreciation. During a market cycle in which real estate values are declining, the higher the leverage carried in a portfolio, the more negative the total return to the portfolio may be. Thus, overall leverage levels should be monitored constantly, particularly during depreciating property market cycles. The less leverage utilized within a portfolio, the less volatile the portfolio will be. Since leverage serves to magnify all systematic or market risks intrinsic in each asset class, this added volatility can not be totally eliminated.
2. **Refinancing Risk:** Refinancing risk arises when a loan becomes due. If market interest rates are higher and/or property values are declining when loans mature, refinancing options become limited. This may create the need for increased liquidity in the portfolio. That is, additional equity could be required invested at a time when real estate could be at or above its target allocation. Actively managing the amount of debt that matures in a single year by staggering debt maturities should reduce this risk within a portfolio. Also, maintaining debt service coverage ratios above policy

or market minimum underwriting requirements will enhance the ability to rollover debt at its maturity.

3. Default Risk: In a recession or in a market cycle when real estate values are declining, a property's Net Operating Income may decrease, thereby, increasing the risk of a loan default. Additional liquidity needs could result if CalPERS is forced to cure defaults. That is, additional equity could be required invested at a time when real estate could be at or above its target allocation. Actively managing overall leverage levels, debt service coverage levels, pruning poorer performing assets and operating above minimum policy or market underwriting requirements should reduce default risk.

IV. GLOSSARY OF TERMS

The Real Estate Glossary of Terms is referenced in the System's Master Glossary of Terms.